Solution 18.1

One of the two types of contingent liabilities is
- a possible obligation
- that arose from past events and
- whose existence will be confirmed only by the occurrence or non-occurrence
- of one or more uncertain future events
- not wholly within the control of the entity.

Initially, Bigmouth Limited would have planned to treat the possible costs of C800 000 as a contingent liability since:
- there are possible legal fees and settlement costs (possible obligation with a possible loss of economic benefits);
- resulting from alleged defamation charges (past event);
- whose existence would only be confirmed by an unfavourable decision in the law suit (uncertain future event);
- which would be decided by the court (therefore not wholly in the control of the entity).

Bigmouth Limited would therefore have been planning to disclose the item in the notes to the annual financial statements as a contingent liability and would not have been planning to recognise it in the balance sheet.

Adjusting post reporting period events are events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that provide further evidence of the conditions that existed at the end of the reporting period.

More information came to light during the period after the end of the reporting period, which indicated that a provision should have been recognised at year-end (instead of the disclosure of a contingent liability). This is an adjusting post reporting period event since it provides more information about a court case that was already in existence at the end of the reporting period.

A provision (liability of uncertain timing or amount) for C1 050 000 (C900 000 + C150 000) should be recognised at year-end.

Solution 18.2

a)

Adjusting post reporting period events are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that provide further evidence of conditions that existed at the end of the reporting period.

The insolvency of Salmon Fish Shop should be classified as an adjusting post reporting period event because the debtor existed at the end of the reporting period and, assuming that Salmon Fish Shop was already experiencing trading difficulties at 31 December 20X0, the insolvency provides further evidence of the debtor's condition at the reporting period date.

b) Disclosure

PENGUIN FOODS LIMITED EXTRACT FROM STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X0		
Profit for the period	*Decrease by: (136 000 X 0.85)*	x - 115 600
Taxation	*Decrease by: (115 600 X 30%)*	x - 34 680

PENGUIN FOODS LIMITED EXTRACT FROM STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X0		
ASSETS		
Current assets		
Accounts receivable	*Decrease by: (136 000 X 0.85)*	x - 115 600
EQUITY AND LIABLITIES		
Retained earnings	*Decrease by: (115 600 – 34 680)*	x - 80 920
Current liabilities		
Current tax liability	*Decrease by: (115 600 X 30%)*	x - 34 680

Solution 18.3

Post reporting period events are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. The end of the reporting period in this situation is 30 June 20X5 and the financial statements are authorised for issue on 18 September 20X5.

Two types of events can be identified:

- those that provide evidence of conditions that existed at end of the reporting period (adjusting post reporting period events); and
- those that are indicative of conditions that arose after the end of the reporting period (non-adjusting post reporting period events).

An entity shall adjust the amounts recognised in its financial statements to reflect adjusting post reporting period events. An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting post reporting period events.

a) This is an adjusting post reporting period event as it provides evidence of conditions that existed at the end of the reporting period. The reasons for the competitor's price reductions will not have arisen overnight, but will normally have occurred over a period of time, maybe due to superior investment in technology.

   An impairment expense of C1 500 000 should be recognised and the amount included as inventory on the Statement of Financial Position reduced to C5 000 000.

	Debit	Credit
Inventory write-down (expense)	1 500 000	
Inventory (asset)		1 500 000
Impairment of inventory following drop in selling price		

b) This is a non-adjusting post reporting period event as it is indicative of conditions that arose after the end of the reporting period. The tropical storm occurred during late August 20X5, after the end of the reporting period.

   Disclosure is required of the nature of the event (the tropical storm) and an estimate of the financial effect (C3 000 000).

c) This is an adjusting post reporting period event as it provides evidence of conditions that existed at the end of the reporting period. The insolvency of a debtor and the inability to pay usually builds up over a period of time and it has therefore been assumed that he was in financial difficulty at year-end.

   A bad debts expense of C400 000 should be recognised and the amount of the accounts receivable on the statement of financial position reduced by C400 000.

	Debit	Credit
Bad/ doubtful debts (expense)	400 000	
Accounts receivable: provision for doubtful debts (asset)		400 000
Doubtful debt written off		

Solution 18.3 continued …

d) This is a non-adjusting post reporting period event as it is indicative of conditions that arose after the end of the reporting period. The insolvency of this customer arose solely by the tropical storm, which occurred after the end of the reporting period, 30 June.

   Disclosure is required of the nature of the event (the tropical storm which destroyed the customer's premises) and an estimate of the financial effect (C105 000).

e) This is not a post reporting period event as defined, as it occurred after the financial statements were authorised for issue. No adjustment or disclosure is required in the financial statements for the year to 30 June 20X5.

Solution 18.4

a) Insolvent debtor

i Adjusting post-reporting period event.

ii The event is the vandalism. Since the vandalism that caused the insolvency occurred before year-end (December 20X3), the event is a past event. The announcement therefore provides information regarding a condition that was already in existence at year-end. The measurement of the asset (debtors) at year-end must therefore be adjusted.

iii The adjustment: the debtor's balance needs to be written down by C80 000 (C100 000 – C100 000 x 0.20).

	Debit	Credit
Bad/ doubtful debt expense	80 000	
Accounts receivable (asset)		80 000
Doubtful debt written off		

b) Drop in value of investment in shares

i Non-adjusting post-reporting period event.

ii The event causing the drop in value was the outbreak of war. Since the war broke out after the end of the reporting period, the event is not a past event.

iii Since the drop in value is material, the drop in the value of the investment should be disclosed since this will affect the users' decision making.

c) Issue of shares

i No adjustment is required.

ii The share issue will take place (10 May 20X4) after the financial statements are authorized for issue (5 May 20X4) and therefore after the end of the post reporting period.

iii The issue would therefore not be recognized or disclosed in the financial statements for the year ended 31 December 20X3.

Solution 18.5

a)
The issue is to determine the correct treatment of the guarantee. The fact that new information came to light after the draft financial statements were prepared (at the end of the reporting period) will result in either an adjusting or non-adjusting post reporting period event.

IAS 37 defines a provision as a liability of uncertain timing or amount. Thus it is necessary to firstly determine whether or not there is a liability. The Framework defines a liability as:
- A present obligation of the entity
- As a result of a past event
- The settlement of which will result in an outflow of resources.

In determining whether or not a present obligation exists, IAS 37 provides further guidance in stating that a present obligation may be a legal or a constructive obligation. A legal obligation is an obligation that derives from:

- a contract (through its explicit or implicit terms),
- legislation, or
- other operation of law.

The signing of the guarantee is a legal obligation because a guarantee is a contract, which states that one person will fulfil the obligations of another in the event of a default.

IAS 37 states that a provision should be recognised when

- there is a present legal obligation as a result of a past event, and, (applying the recognition criteria),
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
- a reliable estimate can be made of the obligation.

A past event that leads to a present obligation is called an obligating event. The obligating event is the giving of the guarantee but at 30 June 20X3 there appears to be no present legal obligation since the directors believed the financial condition to be sound, in which case there is also therefore no probable outflow of resources at that date. The guarantee would thus not have been recognised as a provision in the draft financial statements, but would have been disclosed as a contingent liability (a *possible* obligation).

A contingent liability is not recognised in the financial statements but disclosure would be made of:
- the description of the nature of the contingent liability,
- an estimate of its financial effect,
- an indication of uncertainties relating to the amount or timing of any outflow, and
- the possibility of any reimbursement.

Solution 18.5 continued …

b)
Adjusting post reporting period events are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that provide further evidence of conditions that *existed* at the end of the reporting period.

The condition of Smithers Limited's financial difficulty was in existence at the end of the reporting period although Simpson Limited did not know about it. However, management of Simpson Limited are now aware that Smithers Limited was in financial difficulty at the end of the reporting period. Smithers Limited is thus required to adjust its draft financial statements at year end to account for the new information.

The recognition criteria for a provision are now met:

- it is probable that an outflow of economic resources will be required to settle the obligation since Smithers Limited has filed for protection from its creditors; and

- a reliable estimate can be made of the amount, the guarantee being documented as C1 million.

A provision for the full amount of C1 million might be appropriate.

Solution 18.6

Non-adjusting post reporting period events are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue, that are indicative of conditions that arose after the end of the reporting period.

The decline in market value of investments is indicative of an event that occurred after the end of the reporting period. No condition of the decline was apparent at the end of the reporting period and the decline in value is clearly indicative of a post reporting period event.

Although no adjustment is required to the market value of investments, disclosure of the decline may be warranted if it is of such importance that it would affect the decision making ability of users. Disclosure would be made of:

- the nature of the event, and
- an estimate of its financial effect.

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Solution 18.7

a) No journal entry required.

Although the debt owing by the customer existed at reporting date, the inability of the customer to pay did not exist at reporting date – this condition only arose in January 20X9 after the fire. Thus reporting the debtor at its full carrying amount of C100 000 is correct at 31 December 20X8, according to circumstances in existence at this date. This is a non-adjusting post reporting period event and no journal entry is required.

b) The delivery of old flowers to a customer occurred before the reporting date. Thus the cause for the court case and expected outflow of C10 000 was already in existence at reporting date. A provision must be raised for this outflow at 31 December 20X8 as it is an adjusting post reporting event.

		Debit	Credit
31/12/X8	Expense – legal claim	10 000	
	Provision for legal claim		10 000
	Provision for legal claim raised		

c) An error has been made in the financial statements – inventory has been overstated by C5 000. The error was made before reporting date, and thus existed at reporting date. This is an adjusting post reporting period event, and it must be corrected.

		Debit	Credit
31/12/X8	Cost of sales	5 000	
	Inventory		5 000

d) No journal entry is required.

The burglary and theft of consumable stores occurred after reporting date, thus the over-valuation of consumable stores on hand was not in existence at reporting date. This is a non-adjusting post-reporting period event.

Solution 18.8

Estimated costs

The estimations by the lawyers as to the settlement costs are *an adjusting event* as they give additional information useful in estimating the obligation that was already in existence at year-end.

A provision for settlement costs must be recognised in the financial statements for the year ended 31 December 20X2 since

- there is a present obligation as the court proceedings have indicated that Lemon Ltd is responsible for the poisoning
- there is a past event, being the court case that began before year-end
- the expected result is an out-of-court settlement of C2 200 000 (the lower of the two estimated costs).

Although an estimate has been made (a settlement of C2 200 000), there is a high degree of estimation and the timing of these payments is uncertain. Therefore, assuming that these estimates are considered to be reliable, these amounts should be recognised in the Statement of Financial Position but disclosed separately under liabilities as a *provision*. (Note that if the estimates were not considered to be reliable, a contingent liability would have to be disclosed in the notes).

Findings by the specialists

The findings of the specialists in January 20X3 are an *adjusting event* since the inventory on hand at year-end was already poisoned.

The 20% of the inventory that is contaminated must be written down to zero:

- C500 000 x 50% = C250 000 on hand;
- C250 000 x 20% = C50 000 being the contaminated portion of the stock on hand; and thus a C50 000 write-down is required;
- C250 000 – C50 000 = C200 000 revised value of inventory on hand.

The warning

The warning from Lemon Ltd's lawyers that there may be more similar cases brought against the company is a *contingent liability* in that:

- there is a possible obligation – no further cases have yet been brought against the company and therefore there is no present obligation
- there is a past event – poisoning of the long-life limes, that leads to the guilty plea in the court case.
- the settlement of which would lead to an outflow of future economic benefits similar to that expected from the current case.

This would be disclosed in the notes but would not be recognised as a liability. The nature of the contingent liability and the fact that an estimate is not possible would need to be disclosed.

Possible returns

The possible returns of marmalade seem remote and therefore there is no need to either disclose or recognise a liability of any kind.